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Decentralisation to promote Regional Development in Indonesia

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DECENTRALISATION TO PROMOTE REGIONAL DEVELOPMENT IN INDONESIA

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By Petar Vujanovic

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ABSTRACT/RÉSUMÉ

Decentralisation to promote regional development in Indonesia

In 1998 Indonesia embarked on an ambitious course of decentralisation. Over a period of a few years, facilitated by financial transfers from the central government, responsibility for many public services and administrative tasks were devolved to local authorities. This process is continuing. Regional development is now very much in the hands of the four sub-national tiers of government. However, the speed of the devolution means that much is being done without the required accompanying skills, technical capacities, resources and oversight. As a result, while good progress has been made nationally along a number dimensions, outcomes in health, education, infrastructure, corruption and the provision of other social services have not improved as quickly as was hoped, and the variance in results across the regions has been enormous. Rather than simply devolving more and more responsibilities to sub-national authorities, the central government needs to take a more strategic view of regional economic development. This includes monitoring the performance of sub-national governments, providing them with technical assistance where needed, encouraging them to emulate the best performers and in the short- to medium-term using grants to direct spending to priority areas. The inter-governmental transfer framework also would benefit from better oversight and a strategic vision. Moreover, the perverse incentives it embodies are driving rent-seeking and the fragmentation of local jurisdictions. In the longer term the objective should be tax autonomy and transfers based exclusively on block grants although this should be conditional on adequate oversight and administrative capacities within the sub-national authorities. Conflicting and overlapping laws and regulations across levels of government are also inhibiting regional development by obstructing private business development and investment. This Working Paper relates to the 2016 OECD Economic Survey of Indonesia (www.oecd.org/eco/surveys/economic-survey-indonesia.htm).

JEL codes: H75, O1, O18, O53, R1, R11, F63

Keywords: Indonesia, regional development, decentralisation, fiscal relations

Décentraliser pour promouvoir le développement régional en Indonésie

En 1998, l'Indonésie s'est engagée dans un ambitieux programme de décentralisation. Facilité par les transferts financiers de l'administration centrale, le processus ainsi mis en place a permis, en l'espace de quelques années, de déléguer aux collectivités locales la responsabilité d'un grand nombre de services publics et de fonctions administratives. Ce processus se poursuit toujours. Désormais, le développement régional est en grande partie du ressort des quatre échelons infranationaux de l'administration. Mais la rapidité avec laquelle se déroule le processus de décentralisation signifie qu'il est mené dans une large mesure en l'absence des compétences, des capacités techniques, des ressources et des efforts de supervision requis. Par conséquent, si des progrès satisfaisants ont été réalisés à plusieurs égards au niveau national, les résultats relatifs à la santé, à l'éducation, aux infrastructures, à la lutte contre la corruption et à la fourniture d'autres services sociaux ne se sont pas améliorés aussi vite qu'il était espéré, et les écarts en la matière entre les régions sont considérables. Au lieu de se contenter de confier toujours plus de responsabilités aux autorités infranationales, l'administration centrale doit appréhender le développement économique régional selon une optique plus stratégique. À cette fin, il est notamment nécessaire de suivre les efforts des administrations infranationales, de leur fournir l'assistance technique dont elles peuvent avoir besoin, de les encourager à s'inspirer de celles qui réussissent le mieux et, à court ou moyen terme, de faire usage de subventions pour diriger les dépenses vers les domaines prioritaires. Il y aurait également intérêt à mieux superviser le système des transferts entre niveaux d'administration et à l'articuler autour d'une vision stratégique. Par ailleurs, les effets d'incitation pervers qui sont inhérents à son fonctionnement favorisent les comportements de recherche de rente et le morcellement des administrations locales. À plus long terme, le but devrait être de renforcer l'autonomie fiscale et de donner aux transferts exclusivement la forme de dotations globales, à condition toutefois qu'une surveillance appropriée soit exercée et que les administrations infranationales soient pourvues de capacités administratives suffisantes. En outre, l'existence de lois et réglementations divergentes ou qui se recoupent d'un niveau d'administration à l'autre a pour effet d'entraver le développement régional en faisant obstacle au développement des entreprises privées et à leurs investissements. Ce Document de travail se rapporte à l'Étude économique de l'OCDE de l'Indonésie 2016 (www.oecd.org/fr/eco/etudes/etude-economique-indonesie.htm).

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Mots-clés : Indonésie, développement régional, décentralisation, relations budgétaires

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DECENTRALISATION TO PROMOTE REGIONAL DEVELOPMENT IN INDONESIA

Petar Vujanovic¹

Introduction

Indonesia is a vast and diverse country. An almost 2 million square kilometre archipelago spanning three time zones, it is made up of around 17 500 islands, of which around 1 000 are inhabited. Its population of 260 million people makes it the fourth most populous country in the world, and it has over 300 distinct ethnic groups. Moreover, the population is distributed very unevenly, with approximately 55% on the central island of Java, only 7% of the nation's land mass. While Bahasa Indonesia is the national language and lingua franca, there are around 34 other languages spoken by at least half a million people and 726 spoken languages in total. Cultural and religious diversity is also striking. While Islam is the majority religion (87%), significant populations of Christians (10%), Hindus (2%) and Buddhists (0.7%) are spread across the country. On top of this, Indonesia has been undergoing an impressively smooth political transition to democracy over the past two decades.

This democratic transition has gone hand in hand with a policy of decentralisation. This process accelerated rapidly in response to the Asian economic crisis. The “big bang” decentralisations in 2001 and 2005 handed greater political autonomy to the regions and devolved substantial responsibilities for administration and public services provision from the centre to sub-national governments.

While Indonesia's national motto, ‘Unity in Diversity’, binds the country together, the diversity and complexity of the country makes governing especially challenging. This is true not only in a political sense, but also in formulating economic and social policies that promote the well-being of all Indonesians. Since decentralisation, the nation's diversity takes the political form of 34 provinces and 514 regencies/cities, each having its own government and legislative body (Table 1). A further level is 7 160 districts. Since 2005, four out of the five administrative levels of government have had directly elected leaders, the exception being districts, whose heads are appointed by the regencies/cities, one level above. The diversity across these sub-national entities is large. For instance, provincial populations range from 43 million in West Java to 525 000 in North Kalimantan – a ratio of 81:1. The variance in population across the regencies/cities is even greater, with the smallest (Tambrau in West Papua) having just 6 144 residents, compared to the largest (Bogor in West Java) with 4.8 million. The variance in the size of villages is even greater (see below).

¹ The author is member of the Economics Department of the OECD. He thanks Peter Jarrett, Peter Hoeller, Asa Johansson and Christine Lewis (all of whom are members of the Economics Department) for comments and suggestions. The paper has also benefitted from comments by members of the OECD Economic Development and Review Committee. Special thanks go to Anne Legendre for statistical assistance and Dacil Kurzweg (also from the Economics Department) for assistance in preparing this document.

Table.1. The levels of government in Indonesia, as of end-2015

Type	Type (Indonesian)	Head of administration (English)	Head of administration (Indonesian)	Number
Central	Central	President (elected)	Presiden	1
Province	Provinsi	Governor (elected)	Gubernur	34
Regency & City	Kabupaten & Kota	Regent & Mayor (elected)	Bupati & Wali kota	416 & 98
District	Kecamatan	Head of district (appointed)	Camat	7 160
Village	Desa & Kelurahan	Chief (elected for village, appointed for Kelurahan)	Kepala desa / Lurah	83 184

Source: Statistics Indonesia (based on Ministry of Home Affairs, Regulation no.56/ 2015).

The objective of regional development is to improve the well-being of all – to promote national development by assisting lagging regions to catch up with those at the frontier – not only in terms of just economic growth, but also education, health and environmental outcomes. Indeed, these are all co-requisites for sustainable and inclusive development – especially for a developing country like Indonesia (OECD, 2012d). In the Indonesian context this means not only giving sub-national governments the resources required to make the investments needed to enhance the competitiveness of their jurisdictions, but also the necessary resources to improve the provision of basic services and the capacity to put in place appropriate social, structural and regulatory policies.

With decentralisation, the goal of regional economic development is now very much in the hands of sub-national entities who are responsible for the delivery of public services, the rationale being better accountability and service delivery through increased responsiveness to local needs (Faguet, 2014), often called "subsidiarity". Indeed, the politics of decentralisation in Indonesia has meant that regencies/cities and districts have been favoured over provinces in terms of receiving downward devolved responsibilities (Malley, 2009). Decentralisation can improve performance by promoting competition between regions in the efficient provision of services and attracting businesses. Regions can also draw lessons from each other and benefit from best practice (OECD and KIPF, 2016).

In Indonesia regional autonomy has not delivered the improvements that were expected when launched in 2001, in terms of the provision of public services or in the management of natural resources (Resosudarmo et al., 2014; Buehler, 2010; Moeliono et al., 2009; World Bank, 2009). This is despite a steady increase in transfers from the central to sub-national governments – these now make up about half of the central government budget (net of subsidies and interest payments; about 6% of GDP), and in 2015 over 65% of this amount accrued to the regencies/cities (*kabupaten/kota*). Furthermore, despite some evidence of convergence across the regions, the variance in social-economic outcomes remains large. This includes fundamentals such as education, health, infrastructure, the rule of law (including corruption), the quality of business regulation and the capacity of sub-national governments to administer the provision of public services competently and efficiently. Indeed, research finds that fiscal decentralisation tends to increase regional disparities in poorer countries, while it is either neutral or tends to reduce disparities in richer countries (Rodríguez-Pose and Ezcurra, 2011; Lessmann, 2012). Institutional quality is an important factor: decentralisation seems to foster convergence when institutional quality is high, while it tends to exacerbate disparities in a low-quality environment, fuelling local capture (Kyriacou et al., 2015; Bartolini et al., 2016). This is first and foremost where policymakers' efforts need to focus. Without these fundamentals in place, the blossoming of economic activity in the regions will be constrained, and they will become increasingly dependent on central government funding.

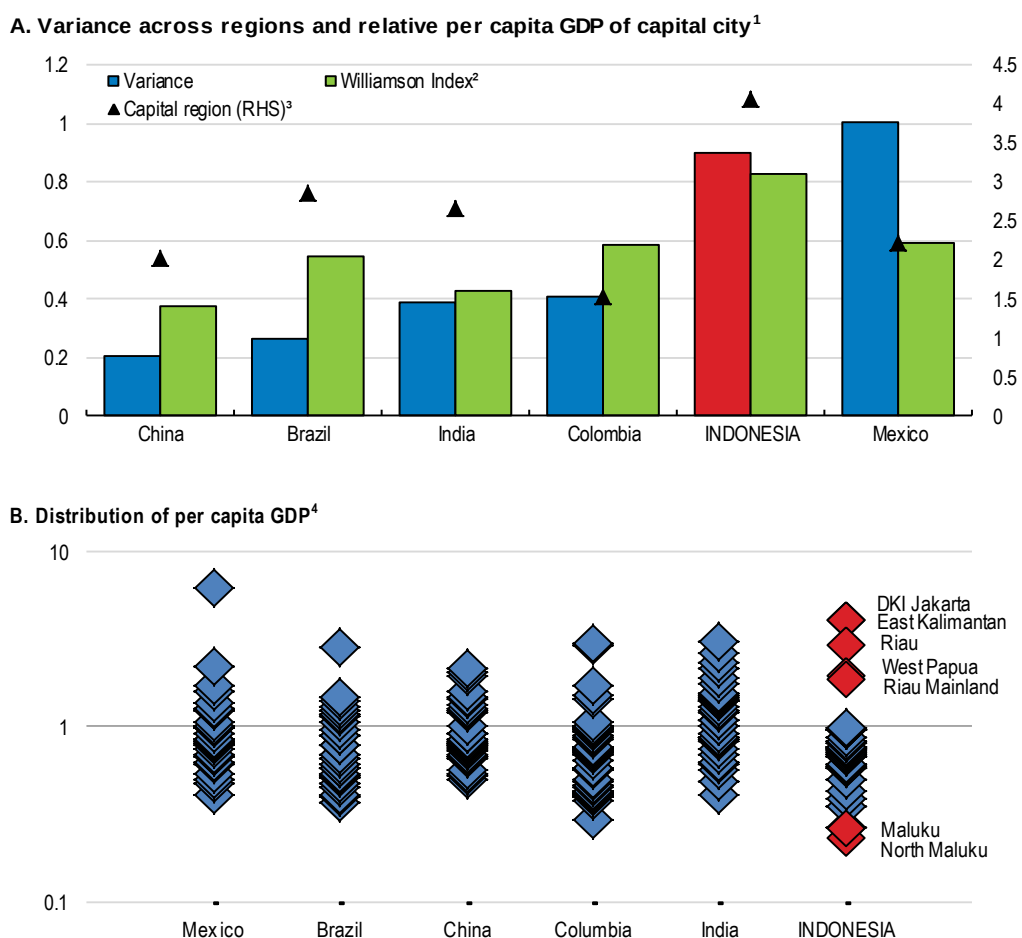
This paper looks at the challenges Indonesia faces in regional development from the perspective of decentralisation. Even though impressive progress has been made in improving the well-being of its citizens, advances have not been even across the archipelago, with a variance in outcomes considerably greater than in other countries at similar levels of development. The paper will examine why regional development is particularly challenging, given Indonesia's geographical, historical and political context. The process of democratisation and decentralisation has happened very quickly; yet there is a sense that it is incomplete. Jurisdictions often remain ill-defined or overlap, and local legislation and regulations are frequently at odds with national policies. And because it has happened so quickly, the checks and balances needed for good governance have had very little time to evolve organically. Indeed, the capacity of the sub-national governments – from the 34 provinces to the 83 000 villages – to deliver high-quality public services is often lacking, and so are the frameworks that monitor the proper and efficient use of public resources. Corruption is also a huge issue at the regional level, which, given the lack of efficient legal and administrative means, is the way business is conducted. It nevertheless entrenches privilege and impedes equal opportunity for all. Finally, the programmes currently in place to promote business development in the regions have been ineffective. These programmes have focused excessively on attracting investment through fiscal incentives, rather than improving the business climate and assisting regional firms to become nationally and internationally competitive.

Progress in regional development has been mixed

Indonesia has made great strides in improving the quality of life of its people. In the years since independence, social and economic outcomes have improved steadily, including in the realms of health, poverty and literacy. For instance, between 1960 and 2015 life expectancy at birth increased from around 49 to 69 years, and infant mortality (per 1 000 births) fell from 148 to 23. Likewise, the \$1.90 (2011 PPP) per day poverty rate has dropped from 72% in 1984 to 16% in 2010. The female literacy rate increased from 57% in 1980 to 90% in 2011. Nevertheless, as in many other developing countries, these national averages mask large within-country variances. Moreover, on some metrics, these variances across regions are particularly pronounced in Indonesia.

Looking at real GDP per capita, the variance across the Indonesian provinces in 2013 was high compared to a range of other developing countries (Figure 1.1, Panel A). The difference in per capita GDP in the national capital compared to the national average was particularly pronounced – Jakarta's per capita GDP is over four times the national average. Besides the imbalance due to the capital city region, Panel B of Figure 1.1 points to other reasons for the high variance in provincial incomes in Indonesia. The richer regions are those that are resource rich, like East Kalimantan (oil), Papua (copper and gold), Riau and Riau Island (oil, gas and palm oil). At the other end of the scale, the poorest regions tend to be remote islands that largely lack natural resources like Maluku. It is these outliers at both ends of the range that account for

Figure 1. Per capita GDP of regions in selected countries, 2013



1. Variance of the ratio of regional GDP per capita in current local currency to national average. Sample restricted to those countries with around thirty TL2-size regions. 2012 data for Brazil and Indonesia.

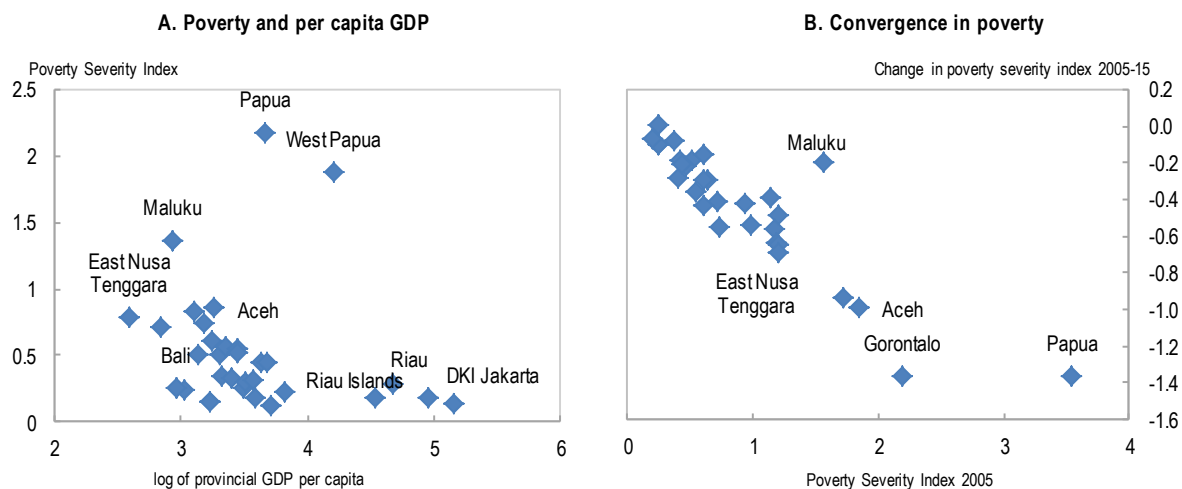
2. The Williamson Index is a measure of variance that weights regions by their share of the national population.

3. Ratio of capital city region GDP per capita to national average.

4. Log of ratio of regional GDP per capita (current local currency) to national average.

Source: OECD Regional Database.

a large part of the high level of inter-regional variance in incomes. Yet, per capita GDP is not the best measure of the standard of living, in particular in these resource-rich provinces, where a significant proportion of the income from the extraction of commodities is likely to flow outside the province. This is confirmed when looking at the distribution of real consumption expenditures across provinces. For instance, West Papua's ranking drops from being the fourth richest province in real GDP per capita to sixteenth in real consumption per household. West Papua's low ranking by spending, despite its resource revenues, is corroborated when looking at poverty (Figure 2).

Figure 2. **Poverty severity and convergence in poverty across Indonesian provinces**¹

1. The province of West Papua did not exist in 2005 and is included as part of Papua in Panel B.

Source: Statistics Indonesia.

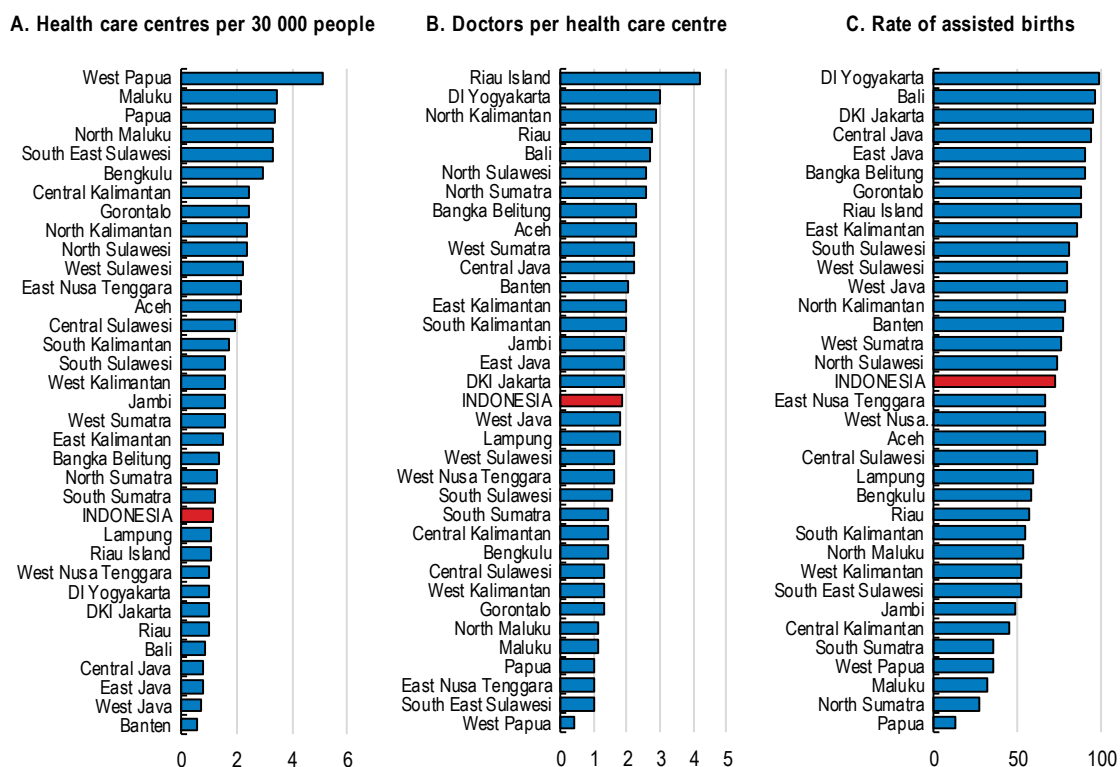
Inequality is higher within urban areas when compared to rural areas, but the prevalence of poverty is greater in rural areas. The strong trend to urbanisation over recent decades is therefore working to reduce aggregate poverty but is increasing income inequality.

Measures to address poverty operate at all levels of government. The fiscal equalisation formula used to calculate the level of transfers from the central to regional governments includes the prevalence of poverty as a parameter (see below for further details). The minimum wage is also a poverty reduction strategy, although an imperfect one because those subject to it may come from affluent households, it may prevent jobs from being created, and it applies only to those employed in the formal sector. Additionally, there are various government measures that address poverty directly, including targeted conditional (Programme Keluarga Harapan or PKH) and unconditional cash transfers and the RASKIN rice programme. Nevertheless, regarding reducing poverty in the regions that most need assistance, it is the targeting of these programmes that is critical World Bank (2012d). This was discussed at some length in the 2015 OECD Economic Survey of Indonesia (OECD, 2015a). In particular, work on increasing the coverage and improving the accuracy of the PPLS14 database of the 40% poorest Indonesians should continue. At the regional level poverty-alleviation programmes still focus on meeting the basic needs of the poor, rather than addressing the underlying causes of poverty or providing long-term growth and employment opportunities. Most programmes are driven by national mandates and agency priorities, rather than by locally perceived needs. Unconditional transfers to sub-national entities, such as provided for by the 2014 Village Law (see below), are mostly politically motivated and are unlikely to be helpful (Andrianto, 2006).

Health

Like poverty, health outcomes have improved markedly over the past few decades. There have been impressive increases in life expectancy and large reductions in infant mortality, for example. Moreover, the provision of health care services and related infrastructure has improved markedly. While this does not necessarily indicate anything about the quality of available health care, the target of having an accessible health care centre (*puskesmas*) for every 30 000 people has been achieved in all but a few of the most densely populated provinces (Figure 3, Panel A). However, the number of doctors working in these centres varies greatly (Panel B). The low rate of assisted births in some provinces bears testament to the low numbers of health professionals working in health care centres in these same provinces (Panel C).

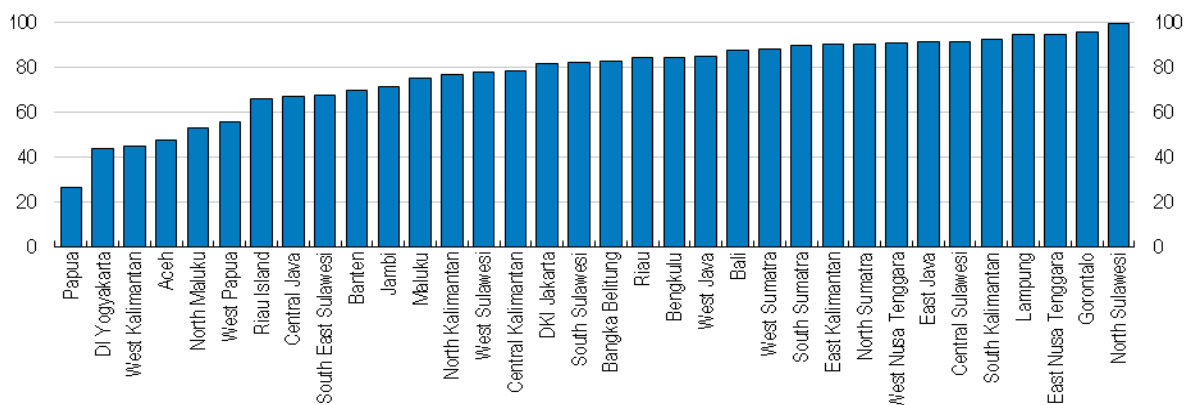
Figure 3. Provincial health care indicators, 2014.



Source: Ministry of Health.

Despite the broad access to health care facilities across the archipelago, as for poverty, large differentials in outcomes remain. Taking pulmonary tuberculosis (TB) as an example: with around 200 000 cases reported in 2014, Indonesia has the 13th highest incidence in the world (399 cases per 100 000 people). Moreover, across Indonesia the incidence of TB is not correlated to affluence: the highest incidences are found in the island provinces of Maluku, Sulawesi and Bangka Belitung, while the incidence in Papua is on a par with Bali. However, the differentials in the rates of success of treatment are striking. While in North Sulawesi the treatment success rate is close to 100%, in Papua it is just 26% (Figure 1.4). Moreover, this pattern of success rates across the Indonesian provinces is uncorrelated to the incidence of HIV, which in some countries is a major factor in the incidence and treatability of TB: just 2% of cases in Indonesia are HIV related (WHO, 2014). Particularly troubling is that the capacity to treat tuberculosis has worsened since decentralisation. In 1997, 53% of health centres (*pustu*; smaller and with less staff than a *puskesmas*) provided TB treatment, but only 30% did so in 2007 (GHW, 2013). It is unclear why this situation worsened. Possible explanations include fewer staff at *pustu* than in 1997, reduced availability of drugs, lack of operating funds after decentralisation and government prioritisation of maternal health, which may have diverted attention from other public health programmes.

Figure 4. Treatment success rate of pulmonary tuberculosis, 2014



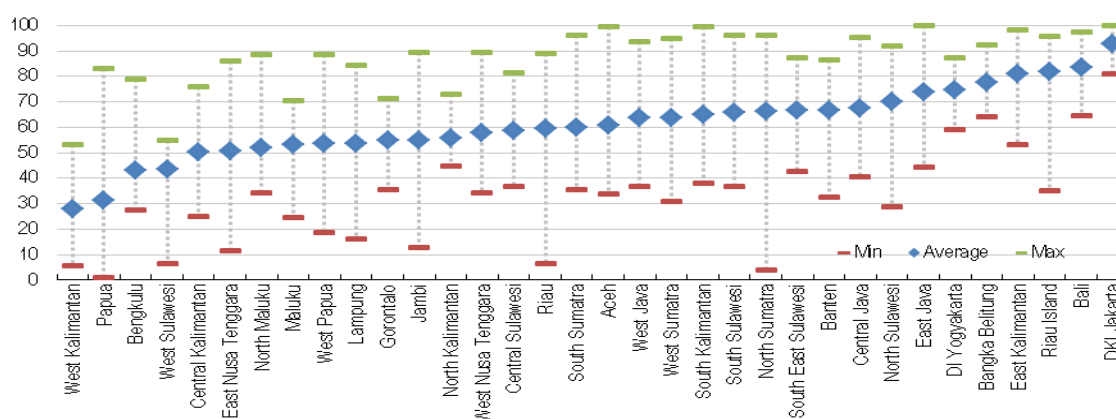
Source: Ministry of Health.

While good progress has been made in the provision of health infrastructure, the focus needs to be on improving the quality of care across the country. This includes staffing health care centres adequately. As in many other countries, attracting qualified and competent professionals to small health care centres in remote regions is challenging. A number of districts have programmes that sponsor medical students through their studies, provided that after graduating they repay this by working for a time in medical centres in the sponsoring district. This practice could be adopted more widely, and indeed the central government could earmark funding for such programmes. Moreover, the low effective density of doctors could also be due to stringent rules that regulate entry into the medical profession, including by foreign medical professionals (OECD, 2012a).

Also from the standpoint of health, particularly children's health, households' access to safe water varies greatly, even across the regencies/cities within individual provinces (Figure 5). Indeed, not just in the poorer eastern provinces, but in almost half of all Indonesian provinces there are regencies/cities where less than a third of households have access to safe drinking water.

Figure 5. Variation in household access to safe water, 2013

% of households, provincial averages and within-province ranges¹



1. Within-province ranges are at the regency/city level.

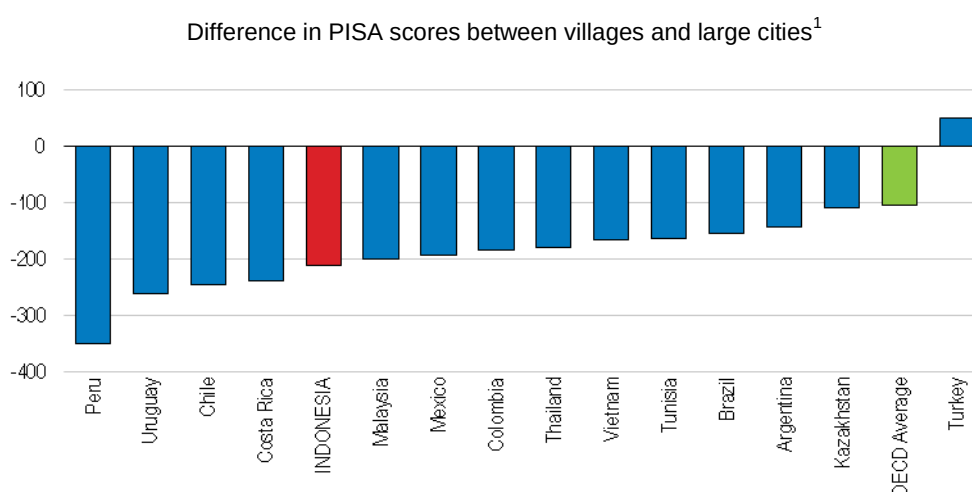
Source: Statistics Indonesia, National Social Economic Survey (SUSENAS).

Education

Much headway has been made in ensuring greater access to education over the past few decades. Successive governments' focus on basic education has paid dividends, with improved attendance at all levels across the archipelago. Nevertheless, there is some way to go to achieve universal primary and lower secondary enrolment, the government's stated objective. For instance, in 2012 9% of regencies/cities had primary school enrolment rates of less than 90%. While this is down from 29% in 1996, it still amounts to 1.3 million children who did not go to primary school (UNESCO, 2015). Enrolment at higher levels is even more heterogeneous across the country and socio-economic groups. For instance, recently only 55% of children from low-income families were enrolled in lower secondary schools (World Bank, 2012c).

As highlighted in the 2015 OECD Economic Survey of Indonesia (OECD, 2015a), Indonesia's average PISA score is close to other countries' at a similar level of development. While a regional breakdown of Indonesia's PISA performance is unavailable, there is a breakdown based on town size. The difference in PISA performance between big cities and villages is comparatively large among developing countries (Figure 6). This might be caused by a number of factors, including accessibility and the quality of teachers (Hayashi et al., 2014).

Figure 6. Rural-urban student performance differentials, selected countries



1. Sum of PISA reading, science and mathematics scores.

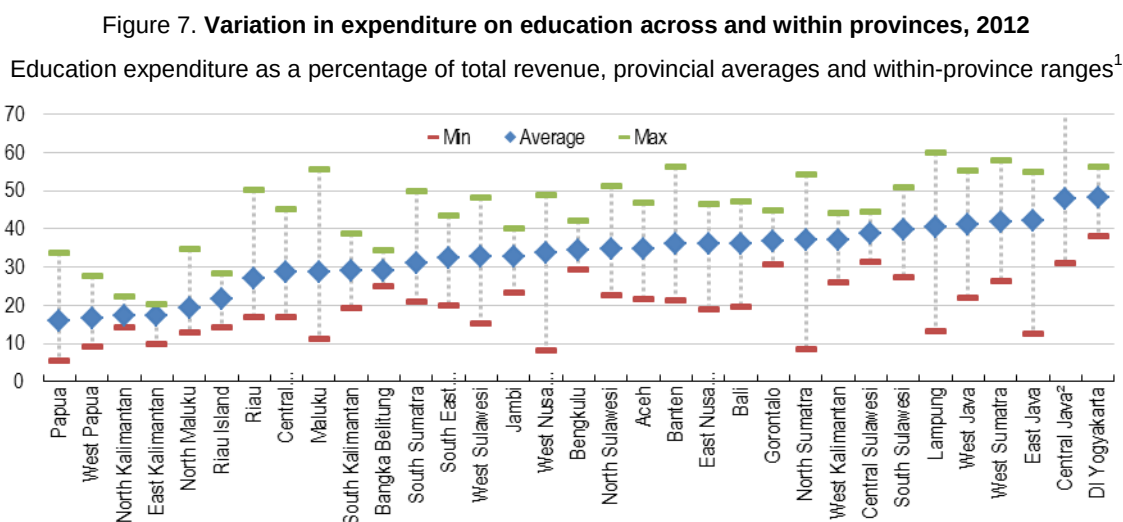
Source: OECD 2012 PISA database.

The supply of teachers and quality of teaching may help to explain variations in student performance across the country. Because of a general oversupply of teachers, Indonesia has one of the lowest pupil-teacher ratios worldwide, and teacher recruitment continues to outpace student enrolment at all levels. Over the past decade the number of teachers in all except Islamic schools rose by 51%, and the national pupil/teacher ratio declined from 20:1 to 15.4:1 (Suharti, 2013). Many rural districts have low pupil-teacher ratios because they have many small schools, but despite this, the rule is that each primary school should have a minimum of nine teachers. Moreover, teachers are attracted to remote locations by allowances that can triple their salaries. So, while it means that rural schools are not generally understaffed, staffing classes of 10 pupils or fewer with a qualified teacher is inefficient (OECD, 2015b).

While data on teacher financing are not readily available, it is clear that increased teacher numbers and increased salaries have accounted for a growing share of education budgets (World Bank 2013a; Kristiansen and Pratikno, 2006). With decentralisation, the number of teachers is set by the central government based on the number of students and schools. Recruitment and salaries are effectively set by

the local governments who are fully compensated by central government transfers (see below). This creates a perverse incentive for the regions to increase teacher numbers regardless of needs or competencies. More should be done to assist sub-national governments to fully and efficiently allocate their education spending. This includes rewarding teachers for performance and not just academic qualifications and seniority.

Whereas education policy and standards have remained the responsibility of the central government since 2001, the delivery of basic education has been that of the regency/city governments. This has provided more opportunities for parental participation, including greater flexibility and improved access to educational services in certain areas. Since 2005, the constitution has required that all levels of government dedicate 20% of government spending to education. In 2012, 13% of all regencies/cities spent under 20% of their budget on education, while many spend a great deal more (Figure 7).



1. Within-province ranges are at the regency/city level.

2. Within-province maximum for Central Java is 97.3%. Source: Statistics Indonesia, National Social Economic Survey (SUSENAS); INDO-DAPOER database.

Regional infrastructure

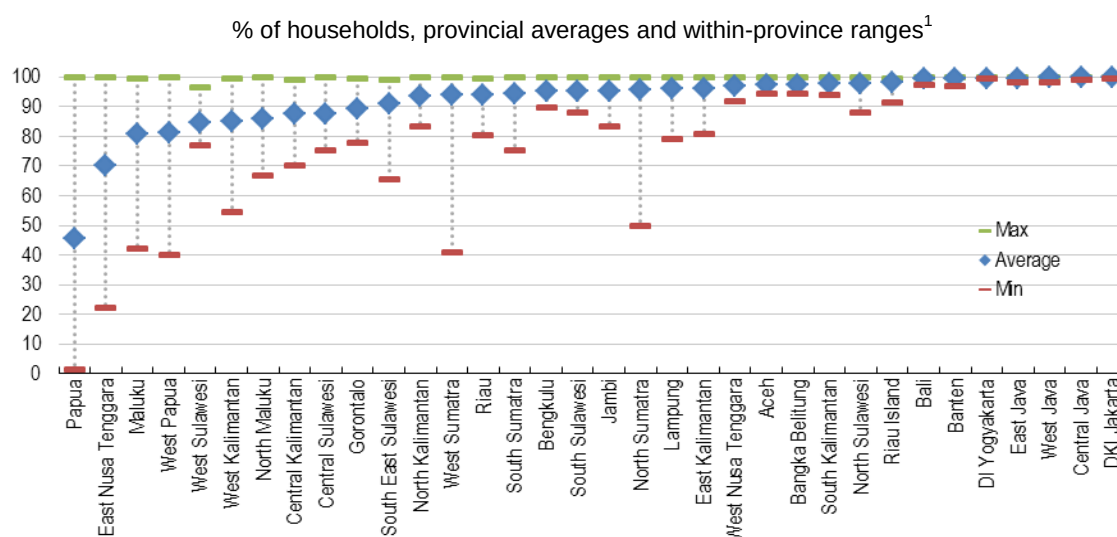
Access to basic infrastructure also varies enormously. Decentralisation devolved much infrastructure expenditure, such as on local roads and water treatment, to sub-national governments. The central government's share in infrastructure investment fell from around 80% before decentralisation (1995-2000) to about 35% a decade later (World Bank, 2013b). While local governments are in a better position to assess regional infrastructure needs, this poses the challenge of effective coordination of sub-national measures and regulations with national plans, such as the MP3EI (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*; Masterplan for the Acceleration and Expansion of Indonesian Economic Development). More generally, the experience of OECD countries is that greater decentralisation is associated with higher levels of public investment (Blöchliger et al., 2013; Fredriksen, 2013).

Electricity

In terms of provincial averages, household access to electricity varies from 46% in Papua to 100% in the large metropolitan provinces like Jakarta (Figure 8). But the variance is particularly stark when looking at household electricity access across the regencies/cities within each province. For instance, in West Sumatra where the provincial average is 94%, on the island regency of Kepulauan Mentawai it is only 41%. The

situation is even more severe in the two Papua provinces, East Nusa Tenggara and Maluku in which some regencies have almost no access to electricity. The government has recently inaugurated the Indonesia Terang (Bright Indonesia) programme, which is intended to develop electricity infrastructure in several remote areas and provide as many as 12 700 villages with access to electricity. In addition to improving households' quality of life, business will of course also benefit from cheaper and more reliable sources of power.

Figure 8. Variation in household access to electricity across and within provinces, 2013



1. Within-province ranges are at the regency/city level.

Source: Statistics Indonesia, National Social Economic Survey (SUSENAS).

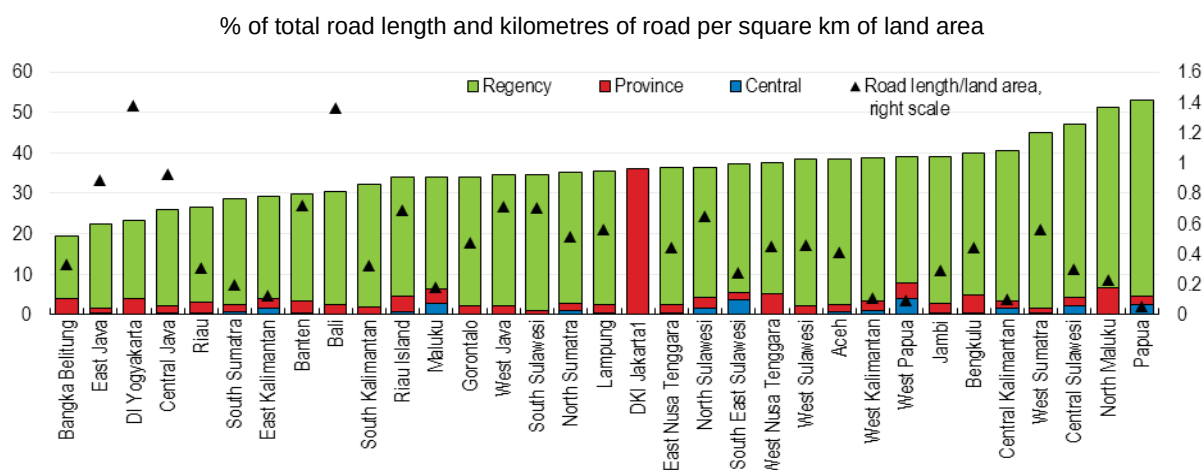
Transportation

While access to services like education, water and electricity is important for the quality of life, transportation links are crucial for regional economic development. Insufficient in quantity and inadequate in quality, Indonesia's transport infrastructure is a serious bottleneck to its economic development (OECD, 2011a). According to the World Bank's World Development Indicators, the increase in road density (kilometres per land area) in Indonesia has been modest by comparison with many other rapidly developing countries, while the total length of railways has actually declined over the past 30 years. Moreover, the maintenance of transport infrastructure has also been poor, with most of the district and city roads, which account for nearly 80% of the network, recently considered in bad condition (World Bank, 2012b). Indeed, in some provinces, around half of roads are ill-maintained (Figure 9). While the total number of vehicles increased threefold between 2001 and 2010, the national road network, which serves more than one-third of vehicle traffic (in vehicle-kilometres), grew by only a quarter. Gertler et al. (2014) show that improved road quality increases firms' value added, total factor productivity and labour demand through new business entry. Structural shifts away from the agriculture/informal sector to the high-productivity manufacturing/formal sector are faster where road quality is higher. Fiscal incentives should be provided to sub-national governments to ensure adequate road maintenance. For example, national government co-financing of sub-national road investment could be made conditional on adequate road maintenance within sub-national jurisdictions.

Existing government programmes for regional development

The Integrated Economic Development Zones (Kawasan Pengembangan Ekonomi Terpadu; KAPET) programme was set up almost 20 years ago to promote development in the lagging eastern regions of the country. The target was to attract 20% of all national investment into these regions. Currently there are 13 areas designated as KAPETs, mostly in eastern Indonesia. Among other means, various tax facilities are offered to attract investment to them, including non-collection of VAT and Luxury Sales Tax (LST) on certain luxury goods purchases and postponement of import duty on capital goods and materials for processing. In 2011 a parliamentary committee concluded that KAPETs had not performed up to expectations, attracting only 3.4% of national investment over the period 2005 to 2010 (Farole, 2013). Their weak performance was attributed to: (i) weak management, in particular a lack of capacity of local authorities; (ii) poor central and local government coordination, especially after decentralisation; (iii) deficient infrastructure and facilities; (iv) a lack of funding for investor facilitation in infrastructure development, again especially after decentralisation when funding responsibility passed to the regions; (v) distance of the KAPETs from key markets; and (vi) insufficient tax incentives.

Figure 9. Road disrepair and road density by province¹



1. Roads within each province are divided into three categories (central, provincial, regency) based on administrative responsibility. Roads in disrepair are those deemed to be damaged in the Statistics Indonesia survey.

2. All Jakarta roads are administered by the provincial government. Road length per km² land area is off the chart at 10.5.

Source: Statistics Indonesia.

Indonesia has also set up special economic zones (SEZs) with a view to promoting investment in the regions. There are currently nine SEZs, and it is the government's intention to set up 17 more by 2019. Of the nine current SEZs, only two (Sei Mangkei in North Sumatra and Maloy Batuta in East Kalimantan both of which focus on palm oil processing) have started operations. In November 2015 the government added further inducements for firms to set up within them by offering corporate tax discounts of between 20 and 100% for up to 25 years depending on the level of investment. Under previous regulations, companies could acquire land rights for 30 years and were able to renew them for 10 more years twice, but now also foreigners are allowed to own land outright in SEZs. Moreover, foreign investors are now allowed to set up and manage SEZs. While it is still too early to assess the success of Indonesia's SEZs, most suffer from inadequate infrastructure, especially in light of their often isolated locations (Vidaauri, 2015). Moreover, their potential impact on broader economic development remains uncertain.

Free trade zones (FTZs) have been another strategy for promoting regional economic development. Only one FTZ was ever set up in Indonesia: the Batam, Bintan and Karimun Free Trade Zone (BBK FTZ),

located on the Riau Islands close to Singapore. This FTZ was set up in 2007 and offered investors exemptions from import and export duties, and VAT-exempt imports. No corporate tax advantages were offered. The plan was to lure investment from Singapore, with the additional attraction of comparatively cheap labour and low rents. However, the BBK FTZ has not lived up to hopes, employing just 2 000 workers at end-2015, with its operation bogged down by bureaucracy. For example, the lack of demarcation between the central government-appointed FTZ authority and the regional government was never resolved, creating legal uncertainties for investors (ChannelNewsAsia, 2015). In December 2015, the government announced plans to dissolve this FTZ, converting it into a regular SEZ.

Beyond SEZs, tax incentives are available to promote investment both generally and in specific regions. The rules have been frequently modified, although this is in part due to the regular review and fine-tuning of these facilities. In 2015 (Regulation No. 18/2015) additional tax incentives were introduced for investments made in certain designated business sectors in specific regions. The matrix pairing eligible sectors and regions is voluminous, there being 66 qualified sub-sectors in the non-location-specific category and 77 qualified sub-sectors limited to very specific locations in various regions. While no longer setting a minimum threshold value of investment, these incentives are subject to strict conditions including requiring high local content including absorption of local manpower. The facility consists of an investment allowance of 30% of the total investment, accelerated depreciation, a lower income tax rate for dividends paid to non-residents, loss compensation for 5-10 years depending on the conditions of location, number of domestic workers, expenses on economic and social infrastructure, research and development outlays and the utilisation of domestic raw materials/components. It is still to be seen how effective these incentives will be in terms of attracting private investment to the designated regions.

MP3EI is the most recent plan for the economic development of the regions of Indonesia. Published in May 2011 under the previous Yudhoyono government, it set out a three-stage plan for Indonesia to become a developed country by 2025. The plan was based on accelerated economic growth, relying heavily on private-sector investment, and improving the investment climate through regulatory reform. Twenty-two economic activities that were considered to have high potential for growth were targeted for special attention under eight main programmes: agriculture, mining, energy, industrial, marine, tourism, telecommunications and the development of strategic areas. Among the 22 are bauxite, copper, nickel, coal and oil & gas, timber, oil palm, cocoa, rubber, food agriculture, tourism, steel, defence equipment and steel. The plan divided the archipelago into six main target ‘corridors’, each with a different, but in many cases overlapping economic focus. The aim was to lift GDP growth rate within the economic corridors and to reduce the dominance of Java in Indonesia’s economy. The total investment was valued at IDR 4 012 trillion (USD 437 billion). It was envisaged that the government would contribute around 10% in the form of basic infrastructure, while the remainder was to come from state-owned enterprises (19%), the private sector (51%) and public private partnerships (PPPs) (21%). The bulk of government investment was to be in road, rail, and power and energy infrastructure.

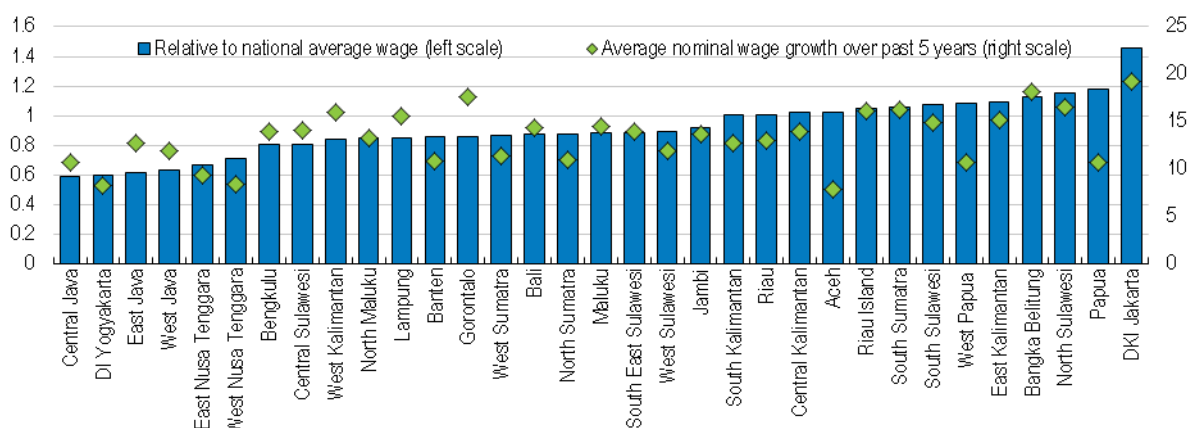
Despite these ambitions, much of the hoped-for investment did not happen within the envisioned timeframe. Right from the beginning, the plan faced challenges including: tight implementation schedules, enormously ambitious private-sector funding, limited capacity within governments to conclude the needed PPP agreements, low levels of human capital to meet the manpower needs across each regional corridor; and real regulatory constraints (OECD, 2012c). The plan was also criticised for focusing too much on ground transportation, for which land acquisition proved to be a real hurdle. Moreover, a large part of the envisaged investment was to take place in Java, already more developed than many other regions of the country.

The current government's Medium Term Development Plan (RPJMN) 2015-19 does not explicitly address regional development in its seven goals or nine development agenda items, although it does aim to improve

welfare and prosperity, while reducing inequality both across households as well as across regions and ensuring that development does not harm the environment.

More flexible wage policy and labour market regulations do not seem to have been considered for use as inducements to lure business investment into the regions, including in the SEZs and FTZ. Indeed, minimum wages, which are set at the regency/city level, do not correlate with economic or labour market conditions across the regions (Figure 10; OECD, 2015a). Moreover, the minimum wage is binding only in the formal sector, and in many of these jurisdictions where the minimum wage is set the government is the largest employer in the formal sector. And given that the minimum wage increases tend to cascade up through the higher pay scales, the considerable minimum wage increases seen over that past several years have effectively translated into large pay rises for regional public servants, the cost of which is covered entirely by transfers from the central government (see below). At the same time, these hefty wage increases have damaged the competitiveness of the regions in attracting business investment. In light of this, the central government's move to cap minimum wage increases to inflation plus annual real GDP growth is welcome, even though in 2016 the increase will be around 11.5%.

Figure 10. Minimum wages and nominal wage growth across provinces, 2015



Source: Statistics Indonesia.

Another policy that has been rolled out to promote business growth is the enterprise registration one-stop-shop programme (Pelayanan Terpadu Satu Pintu; PTSP). The goal of the PTSP is to consolidate business registration and licensing functions in one office, making it easier for firms to register. By 2013 all but four of the 500-odd regencies/cities had set up a one-stop shop. However, research finds relatively little evidence that the programme has increased the rate of (formal) business registration across the regions (Rothenberg et al., 2015; Galiani et al., 2015).

Business surveys and academic research often confirm that fiscal incentives are not one of the most important determinants for attracting investments (OECD, 2010). Many incentives end up subsidising investments that would have been made even without incentives, create rent-seeking opportunities and complicate tax administration. Indonesian authorities are aware of the limitation of using tax policy alone to influence investment decisions and have emphasised more important areas such as macroeconomic stability, infrastructure and public governance. The OECD *Checklist for FDI Incentive Policies* provides policy advice in designing investment incentives: they should be transparent to maximise their intended effects, reduce incentive-related tax planning opportunities and facilitate cost-benefit analyses.

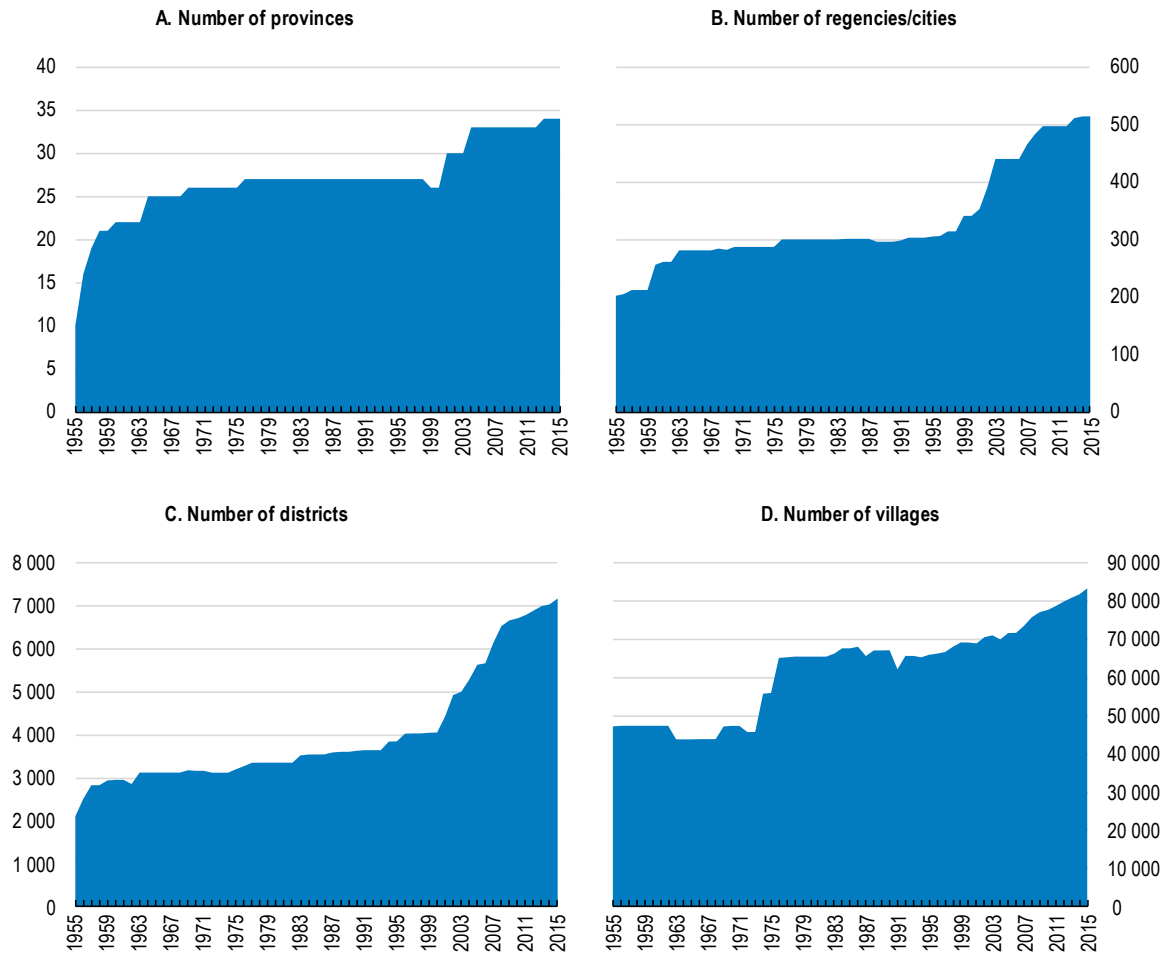
Outcomes have varied enormously. Looking simply at investment, over the five years to 2014 non-building investment per capita in both Jakarta and East Kalimantan (timber, oil and gas) has been 18 times higher

than in East Nusa Tenggara. Despite the efforts of successive governments, investment in the regions outside Jakarta has very much focused on the low valued-added commodity extraction (oil and gas, coal, and metals), palm oil and timber industries. Beyond that there has been too little focus on addressing the investment climate, improving infrastructure and lifting firm-level competitiveness. Moreover, while national programmes such as corporate tax policy and inter-regional logistics are important, the predominant factor in regional development over the past decade and a half has been the massive shift to decentralise government, which has transferred the responsibility for the provision of public services and much of the regulation of business down to sub-national authorities. This includes the licensing of businesses, regulation of investment and land use. More than ever before, the development of the regions is in the hands of these sub-national entities. While the central government provides the financial resources, the regional governments are largely unconstrained in how they are used; indeed, there is an enormous variance across the regions in the mix of spending on public services, and, concomitantly, outcomes have vary widely across the country. Moreover, regional governments have been both discouraged and legally constrained in their capacity to raise their own revenue, and this has frequently pushed them to resort to instruments such as user fees and charges that have hindered business development.

Regional administrative fragmentation continues apace

One of the most striking aspects of decentralisation in Indonesia has been the proliferation and continuing subdivision of political and administrative units. This process, which has been named *pemekaran* (blossoming), has occurred at all sub-national levels of government. (Kimura, 2013). Between 1999 and 2015 the number of provinces increased from 26 to 34, the number of regencies/cities increased by 55%, districts by 77% and villages by 20% to over 83 000 (Figure 11).

Figure 11. Number of sub-national administrative units in Indonesia since 1955



Source: Statistics Indonesia.

The subdivision of a country into small political regions is desirable from a number of perspectives. It brings the provision of public services closer to the people, thereby better meeting needs. A large number of smaller sub-national units also makes it easier for residents to vote with their feet and move to a jurisdiction offering a mix of services and taxes that better match their preferences (Tiebout, 1956). It also provides greater scope for civil participation and political accountability. However, the optimal granularity is very much open to debate, both in terms of size (topographical and demographic) as well as the range of services provided. There is a trade-off between catering for local preferences and the efficiency (the ability to exploit economies of scale, for example) and the technical capacity of small government units.

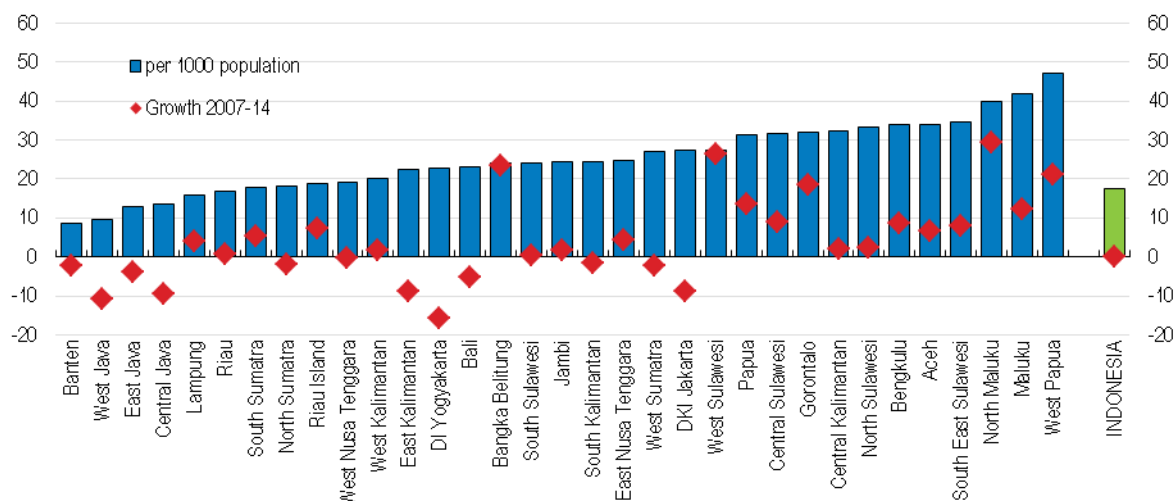
Sub-national politics is undergoing a process of atomisation that is allowing local elites to subdivide power. This process has been tolerated by the central government because it acts as a political pressure valve (Nolan et al., 2013). Kimura (2007) argues that fragmentation since the transition to democracy has largely been in response to vertical coalitions composed of politicians at the national, regional and local levels. Gone are the days when military men or national-level bureaucrats were parachuted in to implement central government policies. In 2005, the direct election of governors, district heads and mayors was introduced, and so political power is now contested by locals with local interests (Buehler, 2013). Burgess et al. (2012) document the pernicious impact that the multiplication of jurisdictions has had on the management of forests in Kalimantan.

The blossoming in the number of political entities at the sub-national level has been mirrored by a boom in the number of public-service jobs. At around 17.5 public servants per 1 000 population, Indonesia has a very high share of government employees compared to peer countries. Lewis (2015) concludes that Indonesian sub-national governments spend too much on administration and personnel and not enough on actual service delivery: indeed, district administrative expenditures are extremely high in international comparison. On average, districts spend around a third of their entire budget on general administration cost, such as wages, and not on public service delivery. Corresponding figures are 3% for US counties and UK districts, 8% for Norway and 13% for Tanzania (Suharnoko Sjahrir et al., 2014). In Indonesia, around 73% of government employees are at the regency/city level, and this is where the highest growth rates have been. This of course reflects the increase in service delivery responsibilities at this level of government, but those provinces with the highest civil-servant densities in 2007 were also those with the strongest growth in the number of civil servants over the subsequent seven years. Moreover, the variance across Indonesia's provinces in public servant density is enormous, ranging from around 10 per 1 000 population in Banten and West Java, to over four times that in Maluku and West Papua (Figure 12). Lewis and Oosterman (2011) argue that while the sub-national governments account for a significant proportion of public investment spending, a large share of this goes to towards relatively unproductive assets such as office buildings. All these indicators suggest that sub-national governments are, in this respect at least, not converging on best practice.

An important factor that has driven the rapid blossoming of new villages in Indonesia over recent years is the system that allocates funds on a per-village basis, largely without regard to population size or the individual needs of each village. This means that subdividing a village into two effectively almost doubles the per capita allocation from the central government. This applies to some degree to all levels of sub-national government; Fitriani et al. (2005) show that the lump-sum nature of Indonesia's general allocation grant (see below) means that "two new districts get effectively twice as much as the larger older district" from which they were formed.

The rise in the number of administrative units has also had broader economic consequences. For instance, the subdividing is frequently done in such a haphazard manner that the geographical boundaries of newly formed administrative units are often left undefined, making spatial planning and land-use zoning problematic, especially from the perspective of businesses wanting to build and invest. Since 1994 there has been a project led by Statistics Indonesia to produce digitised maps of regency/city, district and village-level boundaries. For a country like Indonesia with upwards of 83 000 villages, often in remote and hard-to-access locations, mapping is a massive task, not least because of the constantly changing administrative boundaries, but this project should be prioritised and properly funded.

Figure 12. Number of public servants by province, 2014

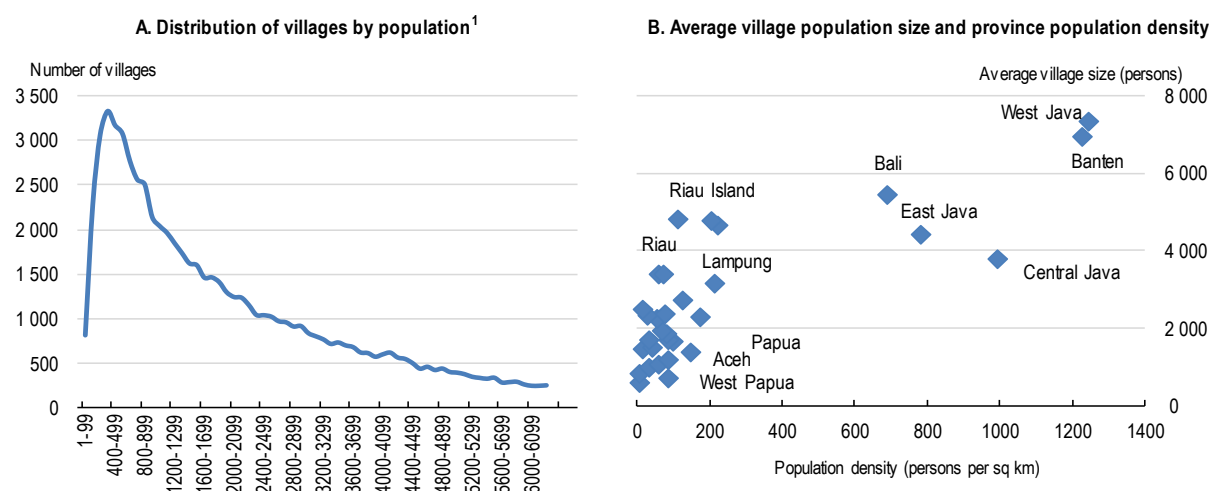


Source: Statistics Indonesia; INDO-DAPOER; OECD estimates.

As in many other countries, including OECD countries such as France, the Czech Republic, Finland and Denmark, very small political units can be costly from a public administration perspective. As mentioned earlier, fragmentation into small administrative units can improve outcomes as local governments closer to the people can implement policies that better match their needs, thus providing goods and services in a more efficient way. However, small operational unit sizes can conversely result in diseconomies of scale and policy and legal fragmentation that impedes firms from operating efficiently across jurisdictions (Bartolini, 2015). Moreover, the small talent pool might mean that the technical capacity of public-sector workers can be a problem. With decentralisation, the district level of administration in Indonesia has been tasked with a broad array of public service delivery responsibilities ranging from education to health. There are around 6 500 districts with a mean size of around 38 000 people and a median of just 24 000. Indeed, there are districts in Indonesia with as few as 200-odd residents (the Syujak district in Tambora regency in West Papua). Likewise, with the new 2014 Village Law, greater resourcing (to reach 10% of total intergovernmental transfers by 2017) and social service delivery responsibilities are being given to villages. However, while as yet the legal and regulatory framework provides only a general indication of village service responsibilities, with over 200 villages comprising less than 50 people (and indeed 13 with less than 10 people; Figure 13; Panel A), the technical capacity to administer these funds and deliver these services, let alone supervise their expenditure, is stretched. The issue of fiscal transfers and village-level governance is discussed in more detail below.

Measures have been taken to put a brake on the fragmentation of sub-national political entities. In 2008 a moratorium was imposed on the formation of new provinces, but then in 2013 the country's 34th province, North Kalimantan, with only 525 000 inhabitants, was sliced out of East Kalimantan province. The Village Law 2014, Article 8 (3.b) specifies the minimum population required for new village formation (for example, in Java 6 000 persons or 1 200 households, and in Papua and West Papua 500 persons or 100 households).

Figure 13. Village population size, 2010



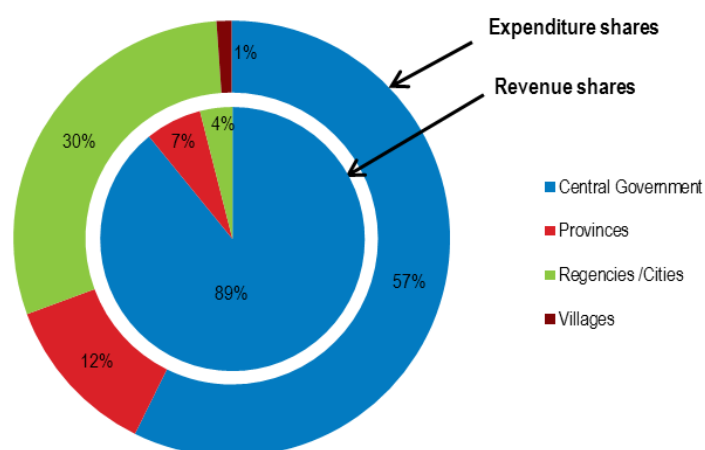
1. There are 8 498 (11% of total) villages with a population of greater than 6 300, although the frequency continues to decrease monotonically with size.

Source: Statistics Indonesia, Census 2010.

Some fiscal aspects of decentralisation could be improved

Over the past decade and a half, Indonesia has gone from being one of the most centralised countries in the world in administrative, fiscal and political terms, characterised by a dominant and authoritarian central government, to one of the most decentralised. Starting in 2001, as devolution of responsibilities for the provision of public services began, the provincial governments, which had previously shouldered a lot of these responsibilities, were leap-frogged in favour of having service delivery responsibilities at lower levels of government. Given that the sub-national governments have very limited revenue-raising capacity, the majority of the funding for these services continues to come via central government transfers. Indeed, in 2015, 89% of all government revenue collected was by the central government, while only 47% of expenditure was incurred by central government (Figure 14).

Figure 14. Revenue and expenditure shares by level of government, 2015



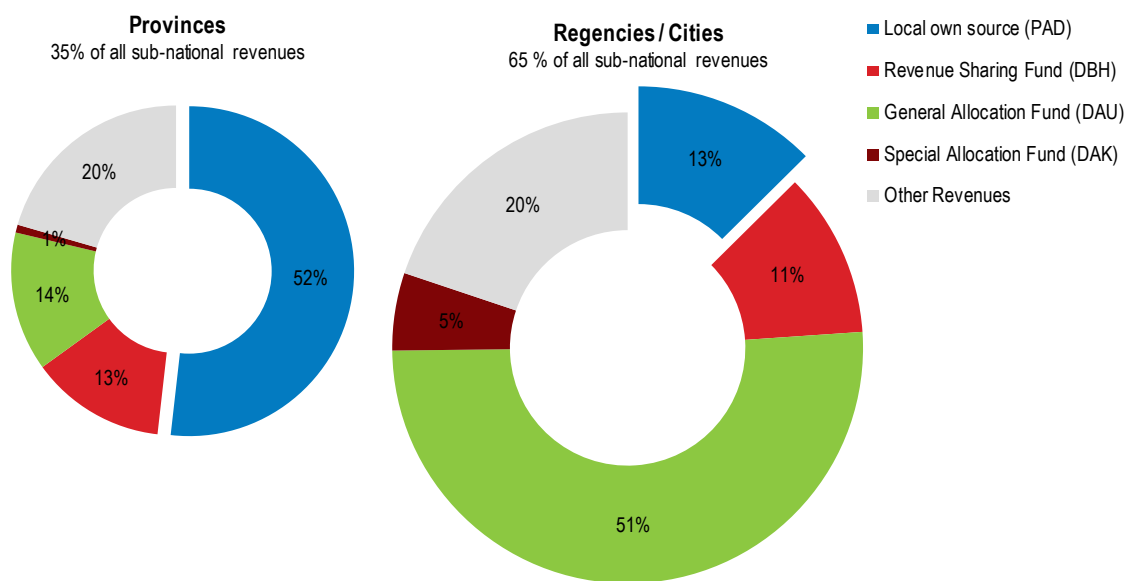
1. The 2015 figure for village expenditure is an OECD estimate. Given the ramping up of the 2014 Village Law, the estimated 2015 village expenditure share is likely to be an underestimate.

Source: Ministry of Finance, Statistics Indonesia; OECD estimates.

Funds from the central government are allocated directly to three sub-national levels of government: namely the provinces, the regencies/cities and villages. Districts are funded and administered by the regencies/cities. In broad terms there are three categories of transfers: (i) equalisation funds; (ii) autonomy funds; and (iii) village funds. Equalisation funds have a number of subcategories. The General Allocation Fund (DAU) is a large block grant, half of which is earmarked for wages and salaries, with the rest unconstrained. The Special Allocation Fund (DAK) is an targeted block grant. The Revenue-Sharing Fund (DBH) redistributes revenues earned from natural resources (forestry, mineral mining, fishery, oil, natural gas and geothermal), and non-natural resources (land and building tax, property tax and income tax). Autonomy funds provide a few resource-rich provinces with a larger share of resource royalties. Village funds are grants directly to villages. The details of each of these transfers, including the formulae used to calculate the distribution among sub-national governments, are discussed in detail below. Finally, there are also deconcentration funds which provide "off-budget" grants directly from central government line ministries to sub-national governments to fund specific national programmes.

In 2015 the regencies/cities accounted for around two-thirds of all revenues at the sub-national level (5.4% of GDP), while provincial revenues accounted for the remaining one-third (2.3% of GDP). By far the largest transfer is the General Allocation Fund (Dana Alokasi Umum; DAU) transfer to the regencies/cities, which accounts for around half of all central government transfers to these two sub-national levels. In addition to revenues from central government transfers, provinces and regencies/cities also raise their own revenues, but they account for only 52% and 13% of total revenues for provinces and regencies/cities, respectively (Figure 15).

Figure 15. Sub-national government revenues by source, 2015



1. Excludes transfers to villages. Other Revenues include Autonomous Regions Funds to Aceh, Papua and West Papua.

Source: Ministry of Finance.

The General Allocation Fund

The largest central government transfer to the regions is the DAU, accounting for 56% of total central transfers and financing 46% of sub-national expenditures. DAU is a block grant paid to the provinces and regencies/cities with a fixed 10/90 split between the two. The formulation that determines its distribution across regional government is heavily weighted towards a basic allocation for public service wages and

salaries; this component is around half. Box 1 gives further details of the formula used to calculate the remainder, based on a fiscal gap.

Box 1. Formula for the distribution of the General Allocation Fund (DAU)

The total national DAU pool is calculated annually by the Ministry of Finance based on the total central government budget. This has typically been around one quarter of total domestic revenue in the national budget. The DAU pool is divided into two parts: (i) the basic allocation and (ii) the fiscal gap.

The basic allocation is intended to cover personnel costs for sub-national civil servants (including teachers and medical staff, etc). This usually amounts to around half of the total DAU pool.

The remainder of the pool is divided among the provinces and the regencies/cities. The split is set by agreement between the government and parliament and is currently 10%-90%. The fiscal gap formula is used to decide how these shares are divided among the provinces and among the regencies/cities. The fiscal gap is the fiscal needs *less* fiscal capacity. The fiscal needs of a region are local expenditures adjusted by population, land area, construction prices and poverty. Fiscal capacity is local revenue adjusted by estimated revenue potential. This is represented by the sum of an industry index, a natural resources index and a human resources index. Local revenue is local own revenue plus any tax-sharing revenues received.

By comparison to other federal countries, the formulation of this transfer is both complex and results in undesirable incentives. For instance, the blanket coverage for public service wages and salaries strongly encourages a large public payroll. The central government imposes some controls over local recruitment and staffing in order to mitigate this perverse incentive. However, at the regency/city level where the DAU represents over half of all revenues (compared to just 14% for provinces), the public payroll is much larger than at the provincial level and also compared to other local governments with similar service delivery responsibilities in peer countries (World Bank, 2005). Indeed, personnel accounted for 47% of all regency/city expenditure in 2014, up from 31% in 2009. This is in contrast to the provincial level where it accounted for just 16% of expenditure in 2014, down from 20% in 2009.

If direct compensation for the local level public payroll is to remain, for the sake of transparency the basic allocation should be separated from the fiscal gap allocation. Furthermore, payroll compensation should not cover 100% of the payroll: the salary of each additional public employee should be compensated at a fixed marginal rate of less than one, with the remainder coming from other non-compensated transfer streams or, even better, from local own-source revenues (see below for recommendations on increasing the share of own-source revenues in regional budgets) so as to encourage regional governments to economise on public-sector hiring.

The formula for the fiscal gap transfer also needs to be reconsidered. Indeed, in many developing countries (such as Brazil, India and Thailand, and in the United Kingdom) very simple per-capita revenue-sharing frameworks are used and explicit grants target social inequality, infrastructure exigencies and other regional inequality issues (Shah et al., 2012). While moving to such a system is very unlikely in Indonesia due to the political economy of decentralisation, reforms are needed that focus on simplicity, transparency and certainty, while enhancing efficiency and citizen-based accountability. Incentivising improvements in outcomes, such as achieving a target poverty rate or reducing road disrepair, should also be designed into the framework; that is not to say that being at or above a target should result in higher payments, but that improvements towards a target should be rewarded. Finally, as mentioned above, the formulation of the DAU perversely rewards regional fragmentation with higher per capita transfers after a province or regency/city is subdivided (Harjowiryo, 2011) and needs to be changed.

The Specific Allocation Fund

The Special Allocation Fund (Dana Alokasi Khusus; DAK) is a grant targeted at spending on areas of national priority. However, in reality the DAK has proven to be not much more specific than the DAU.

Furthermore, the effectiveness of the DAK allocation mechanism in poverty alleviation, boosting economic growth, cutting unemployment and other specific dimensions has been disappointing (Wibowo et al., 2011). This might reflect the small size of the programme, which accounts for just 6% of central government transfers and finances just 5% of sub-national expenditures.

There are also Special Incentives Grants (Dana Insentif Daerah; DID) and Hibah, which used to be earmarked but since 2015 local governments have been free to use them according to local needs. DID is a small grant programme (accounting for less than 1% of total transfers) to better performing provinces and cities based on the quality of public financial management, level of tax effort, progress in improving the Human Development Index, economic growth, reductions in poverty, unemployment and inflation. Hibah transfers are intended to finance sub-national infrastructure and social development expenditures (Qibthiyah, 2011).

Shah et al. (1994) suggest an alternative to DAK grants could be conditional open-ended matching grants, along with intensive ongoing evaluation and monitoring to align the allocation of funds to regions with regional development targets. The World Bank is currently funding a project that allocates the DAK grants in a similar way to Output-Based Approach (OBA) subsidies, which reimburse service providers for independently verified, pre-agreed measurable physical outputs. Both of these approaches have merit and should be tested. More generally, a greater share of transfers should be in the form of earmarked special-purpose grants.

Autonomy transfers

The central government has entered into special arrangements with Aceh, Papua and West Papua to allocate a greater share of resource revenues to them through the tax sharing system. However the DAU offsets a large part of those gains by including 95% of tax sharing transfers as increases in fiscal capacity for the provinces and 63% for regencies/cities. Nevertheless, the total transfers to these three provinces in per capita terms are the highest of any. The use of the autonomy funds goes largely unsupervised by central government and is therefore extremely prone to fraudulent practices by officials from both central and local governments (Jakarta Post, 2011). The Supreme Audit Agency (BPK) found indications that between 2001 and 2010 around 20% of the IDR 19 trillion in special autonomy funds for Papua and West Papua may have been misused or embezzled (Jakarta Post, 2011).

The Revenue Sharing Fund

Dana Bagi Hasil (DBH) are revenue-sharing transfers. The central government collects taxes on personal income, property, and renewable and non-renewable natural resources and returns a pre-defined share of the revenues to the originating jurisdiction. The sharing formula is set out in Law (33/2004). In 2015 DBH accounted for 13% of all provincial revenues and 11% of regency/city revenues.

Village-level transfers

The 2014 Village Law instituted a new system of transfers directly to villages both from the central and regency/city governments (*Dana Desa*); it is to be phased in over a three-year period. In 2015, villages received over IDR 20 trillion (approximately USD 1.5 billion) in *Dana Desa*, which amounts to about 3% of total central-to-subnational transfers. In addition, regencies/cities will be required to contribute 10% of their own-source revenues (PAD), revenue sharing grants (DBH) and general purpose transfers (DAK) – an estimated IDR 40 trillion (USD 3 billion) – to village budgets. Taken together, these funds made up about 3% of all government spending in 2015, and this is set to increase as the scheme is implemented. The majority of the funds (90%) are to be distributed as equal allocations per village, with the remainder based on a “needs” formulation. Indeed, a popular refrain used by both candidates in the 2014 presidential election was ‘*satu desa, satu milyar*’ (‘one village, one billion rupiah’). The basic per-village allocation

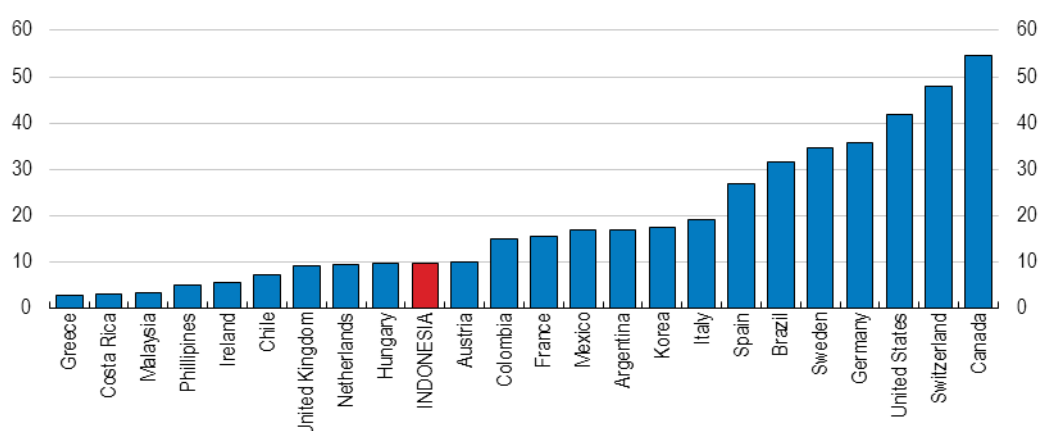
means a median-sized village will receive IDR 325 600 (USD 23) per capita. This uniform per-village allocation runs counter to the very large heterogeneity among villages, including in terms of population, land area and poverty – indeed there are 2 436 villages with one tenth the median population that are set to receive 10 times the median per capita allocation. This brings into question the scheme's equity. The allocation formula needs to be reassessed and an alternative scheme adopted that uses a simple formulation that accounts for population size and poverty prevalence. Also greater use should be made of earmarked grants for village capital needs.

Beside the equity issue, the other major problem with the 2014 Village Law is that villages' service responsibilities are not clearly defined. The legal and regulatory framework provides only a general indication of these responsibilities. Central, provincial and regency/city governments will be responsible for detailing the actual tasks that villages will perform at a later date. Despite claims that 'money follows function' – best practice in fiscal decentralisation – in this case the opposite is true. Furthermore, as yet, no provisions have been made for external audits of village-executed budgets.

Strengthening revenue raising in the regions

On the back of falling resource revenues and rising expenditure demands, including for infrastructure and social spending, the national government is seeking to increase tax revenues. However, while around half of all public spending is at sub-national level, only about a quarter of the revenue is raised locally. Or, put another way, only around 10% of total government revenue is raised at the sub-national level, which is low by international comparison, especially in contrast to other federal countries like Brazil, Canada, Germany, Switzerland and the United States (Figure 16).

Figure 16. Sub-national own-revenue as a share of total government revenue, 2014¹



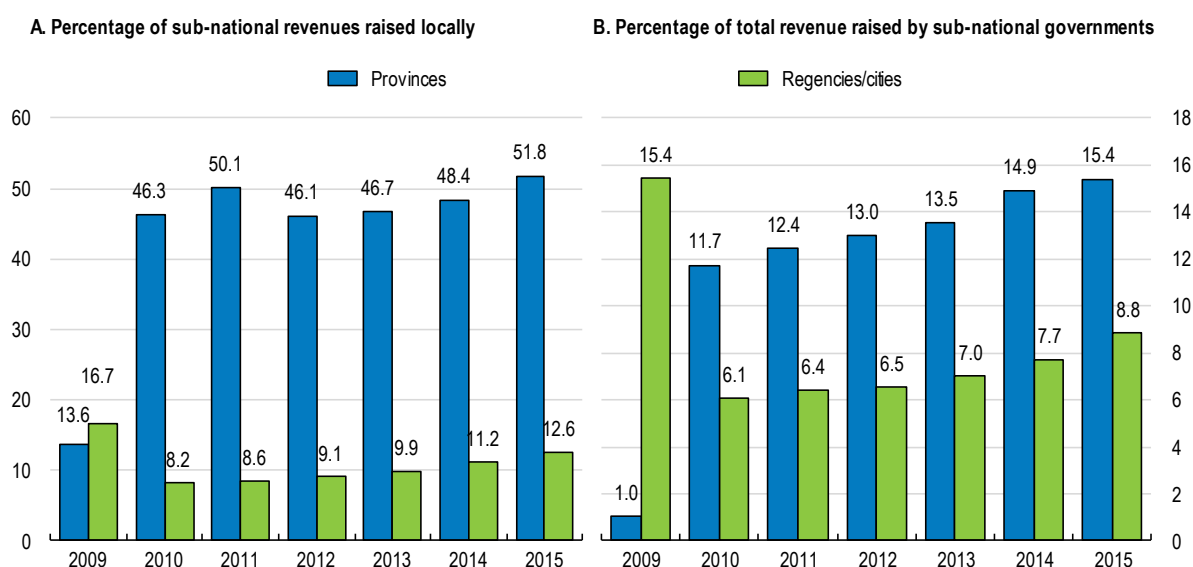
1. 2013 for Indonesia, Philippines, Malaysia, Brazil, Argentina, Colombia, and Costa Rica.

Source: OECD Fiscal Decentralisation Database; OECD (2015), *Revenue Statistics in Asian Countries 2015: Trends in Indonesia, Malaysia and the Philippines*, OECD Publishing; OECD (2016), *Revenue Statistics in Latin America and the Caribbean 2016*, OECD Publishing.

Attempts have been made to promote revenue raising at the sub-national level. Law 34/2000 aimed to promote taxation at the regional level. However, while what constitutes an allowable regional tax under the law adheres to solid taxation principles, the criteria for what is allowed are couched in vague and imprecise terms (for example “not damaging to the economy”). As a consequence, a large proportion of the taxes and user charges that have proliferated are ill-advised and act to inhibit business development and investment (Butt and Parsons, 2012). Law 28/2009 on Regional Taxes and User Charges was intended to address concerns that regional governments were harming the investment climate, particularly by enacting ‘problematic’ taxation and regulations. Additionally, the law transferred a number of taxes from

regencies/cities to provinces, and since then total revenue raised at the sub-national level has increased appreciably, from 16.4% to 24.2% (Figure 17, Panel B). However, the problem with both Laws 34/2000 and 28/2009, and the reason that local governments have resorted to what are often nuisance levies and user charges, is that these statutes do not provide for any major tax instrument, such as personal or business tax, to be collected by sub-national governments.

Figure 17. **Sub-national government own-source revenues (PAD), 2009 to 2015**



Source: Ministry of Finance.

Greater efforts should be made to encourage the regional governments to raise revenue locally. Revenues raised at the local level are desirable on a number of grounds. Local taxation provides a strong incentive to grow the local economy, because that will expand the tax base. Better matching local revenue to local spending strengthens local responsibility and accountability. If the taxes are borne by local (voting) residents, it promotes local civic participation – local residents feel less ownership of transfers from central governments and are therefore less likely to hold local politicians and bureaucrats accountable for how these revenues are used or misused. Of course to the extent local accountability is lacking, there is a risk that the use of revenues raised locally is not scrutinised to the same extent as spending out of central transfers. Moreover, in the Indonesian context, the feasibility of local governments raising appreciable revenues through taxes and charges is in question – local capacity is often lacking, and revenue raising can encourage corruption and rent-seeking. Moreover, there is the fundamental question of which taxes, fees and charges should be allocated to sub-national jurisdictions. A number of principles of good regional taxation are outlined in Box 2.

Box 2. The principles of optimal regional taxation

- (i) Local responsibility and accountability are enhanced if local residents are taxed to pay for the services they consume.
- (ii) The benefit-tax-link principle says that if residents are willing to pay for the public services they receive, then some form of taxation is efficient. This would enhance individual (and/or collective) welfare in the provision of public goods.
- (iii) Local taxation should ideally reflect a regionally equitable revenue pattern for reasons of distributional justice among jurisdictions. This is warranted on political grounds as social fairness and national cohesion enhance political stability. On these grounds, taxes on bases that are unevenly distributed across jurisdictions (like natural resources) are not suited for local use because they can entail large regional inequities. In Indonesia this is particularly relevant, given the importance but uneven distribution of the mineral extraction and oil/gas industries across the country.

(iv) Local governments have to provide services on a continuous and reliable basis. Apart from investment in large local infrastructure projects, which is lumpy and therefore needs to be financed either through borrowing or with the assistance of higher-level governments, steady service provision calls for a reliable and sustainable revenue base that remains largely sheltered from the cyclical variations of economic activity. It is therefore questionable whether municipalities should be given the progressive personal income tax because it tends to exhibit greater fluctuations over the business cycle than other bases. Indeed, local governments may be willing to surrender volatile sources of revenue for more reliable and steady bases. Revenue risks related to the business cycle and risks arising from changes in the regional structure of the economy form yet another rationale for tax sharing between the lower tier and higher-level governments.

(v) Local taxes have to be administered by all municipalities alike, large or small. Since smaller jurisdictions face potentially higher administrative costs per unit of revenue raised than larger ones, the local tax system as a whole is constrained by the former's ability to administer the taxes. Otherwise, regional inequities would result from the effective variance in taxes collected. This calls for a simple local tax system.

Source: P. Spahn (1995), "Local Taxation: Principles and Scope", The World Bank Institute; and OECD and KIPF (2016), *Fiscal Federalism 2016: Making Decentralisation Work*, OECD Publishing.

In the Indonesian context, the principles of good regional taxation may mitigate against a local VAT because, while it could piggy-back on the national VAT or even simply be imposed as a surcharge on the national VAT, the tax credit mechanism and export redemption would make it difficult to administer, particularly given the still low administrative capacity of many local governments. A local turnover tax would interfere with the national VAT. A local retail sales tax might be easier but would also impose a significant administrative burden. Despite their pro-cyclicality, more promising would be local personal income and local business taxes, which are not currently allowed to be levied by non-central governments. The former could take the form of a surcharge or piggy-back tax on the national income tax for reasons of administrative simplicity. Yet, under the conditions prevailing in Indonesia, where personal income tax collection at the national level is still very low, a local income tax would probably raise little revenue. A local business tax would be, however, feasible in the short run if care is taken to keep the base simple. While a local property tax would be the ideal local tax in theory, the existing property taxes levied at the regional level, raise little revenue in practice. Aside from the administrative complexities in determining the base, the reasons for its poor performance in most countries are the political impediments at play at the local level. Another option for motivating local revenue raising is to offer matching grants as Mexico has done since the 1970s (Campbell, 2003; OECD, 2015c).

Measures to improve the provision of infrastructure in the regions

The lack of infrastructure spending by the regions can be attributed to a number of factors. First, local governments spend mainly on social services and their own administrations. In addition to core expenditures like defence, social security and (until recently) energy subsidies, the centre continues to spend substantial amounts on local functions, particularly in health and education. Given the 3% of GDP deficit rule, low revenues by international comparison (OECD, 2015a), and spending targets for education and health, the spending mix has tended not to favour large-scale infrastructure projects. In addition, some public enterprises that have been transferred to local governments, particularly local water-supply utilities (PDAMs), have become insolvent due to mismanagement. While the focus of the central government is currently on infrastructure projects of national significance, more use should be made of tied Special Allocation Grants (see below) to the regions to fund selected smaller-scale projects.

Second, capital budgets tend to be spent in the second half of the fiscal year, which provides too little time to complete large investment projects. The current central/sub-national budget process entails too many uncertainties and interruptions for rolling out complex multi-year infrastructure projects. This needs to be addressed.

Third, as discussed above, the fragmentation of sub-national jurisdictions and, more generally, the rapid growth in the size of sub-national administrations, particularly in terms the number of public servants, means that too much of their capital spending goes towards relatively unproductive assets such as office buildings.

Finally, while national measures have been taken to streamline the process of land acquisition (see the 2015 OECD Economic Survey of Indonesia), one regional aspect is the lack of legal land titling. Indeed, in some regions of Indonesia, particularly in the east, cultural issues differ substantially from the dominant Javanese in so far as the inheritance of land is concerned. For instance, in East Nusa Tenggara (NTT) land is not formally inherited by the next generation but remains the property of all subsequent generations to jointly exploit them. Kristiansen and Sulistiawati (2016) find that rather than resulting in over exploitation, the land is often left under-utilised. Land acquisition laws should be made more flexible so as to encompass regional cultural diversity. Moreover, decentralisation has complicated the process for foreign investors when applying for land titles. Law 32/2004 revoked regional governments' authority to regulate land acquisition, but it has been suggested that some local governments continue to impose additional requirements (Adwani, 2008; World Bank 2012b).

Imprecise division of responsibilities across levels of government

As argued above, there is broad agreement that many public services should be provided at lower levels of government in order to enhance the efficiency of the public sector and to increase its responsiveness to voters' preferences and demands for collective services. The theory of optimal fiscal federalism posits that the services provided at lower levels should be based on three factors. The first is that local government should provide services that most people benefit from – where the tax-benefit linkage is strong. Roads are an example where everyone benefits, and therefore everyone is willing to pay. The second factor is a lack of externalities. If the local public good has positive spill-overs to other communities, it will be under-provided. In this case higher levels of government have a role in promoting its provision. The third factor that determines the optimal level of decentralisation is economies of scale in production. Goods with large economies of scale, like power generation, are not efficiently provided by multiple competing local jurisdictions. This framework therefore predicts that local spending should focus on broad-based programmes with few externalities and few economies of scale.

A decade and a half after the big bang decentralisation in Indonesia, there still remain unclear lines of responsibility for the delivery of public services across levels of government. While Law 23/2014 goes some way to providing broad guidelines, it relies largely on regulation to articulate functional responsibilities. The central government should be more explicit in setting norms, standards, procedures and criteria for local government service delivery responsibilities and provide guidance and supervision. Likewise minimum service standards should be better monitored and enforced.

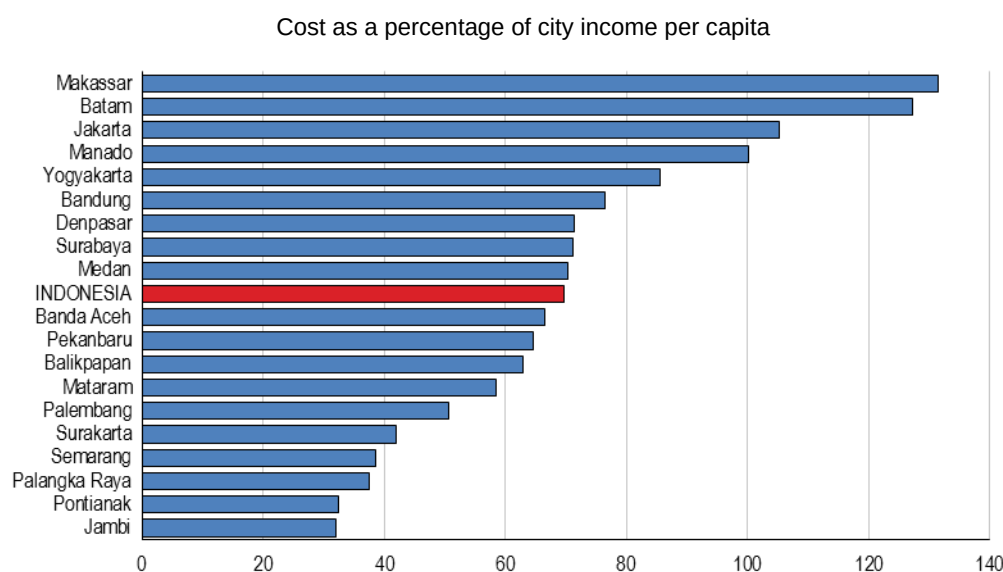
A complicated regulatory environment for business

In Indonesia decentralisation has happened so quickly that, even after a decade and a half, in addition to the imprecise division of responsibilities across levels of government, there remain many jurisdictional regulatory overlaps (Pisani, 2014). The decentralisation law of 1999, which has been modified a number of times, still often clashes with existing laws affecting such important sectors as mining and forestry, making administrative responsibilities unclear for businesses and increasing uncertainty for investors. While some improvements were made in demarcation of responsibilities in 2014, significant issues remain.

With decentralisation, significant legislative powers have devolved to many hundreds of local legislators and executive officials. Local laws can now be enacted at both the provincial and regency/city level, meaning more than 600 legal jurisdictions. Indeed, Butt (2010) estimates that as of 2010 there were over 1000 law-making bodies or individuals across Indonesia. This proliferation of jurisdictions has made for a much more complicated legal environment for businesses and investors. So while Indonesia continues to improve its ranking in the World Bank's Ease of Doing Business Index, this regional legal heterogeneity is not captured in this or other similar metrics. For instance, that Index covers only the two largest cities, Jakarta and Surabaya.

Having said that, in 2010 and 2012 the World Bank did a sub-national analysis of their index in 14 Indonesian cities (World Bank, 2010 and 2012a) and found that there is considerable variance in business regulation across the cities surveyed. For instance, the cost of a construction permit ranges from around the equivalent of 32% of national average per capita annual income (approximately USD 850) in Jambi (Central Sumatra) and Pontianak (West Kalimantan), to around quadruple that (approximately USD 3 450) in Batam (a free trade zone near Singapore) and Makassar (South Sulawesi) (Figure 18). Likewise a construction permit in the city of Bandung takes on average 44 days, while in Jakarta, less than 150 km away, it takes on average 158 days. To start a business in the city of Palangka Raya (in Central Kalimantan), 27 days are needed for the official procedures, while the same steps in Jakarta take 45 days. The large variance in most metrics was attributed in part to the fact that the stringency of enforcement of national regulations varies across cities. Most particularly, starting a business and the high cost of transferring property continue to be challenging for entrepreneurs in most sub-national jurisdictions. These variations indicate that improvements in the regulatory environment can be achieved independently of reforms (or lack thereof) at the national level. Nevertheless, almost all cities surveyed showed progress between 2010 and 2012 in the obstacles to starting and building a business. Even more positively, certain cities within Indonesia ranked much higher in some survey dimensions than many of Indonesia's regional peers, which, in aggregate, tend to outperform Indonesia. This suggests that there is real scope for cities and regions to learn from existing good practices of their Indonesian peers to improve their competitiveness nationally and globally.

Figure 18. Variation in the cost of a construction permit across major Indonesian cities, 2012



Source: World Bank (2012a), *Doing Business in Indonesia 2012*, January, Washington, DC.

Furthermore, as discussed earlier, Law 28/2009 on regional taxes and levies needs to be better enforced so that local governments are prevented from levying user fees and charges that substantially increase the transaction costs of doing business in the regions, both in terms of time and money. Indeed, Law 28/2009 provides the necessary sanctions. Lewis (2015) shows that such user fees and charges constitute a substantial impediment to positive regional development outcomes. In mid-2016 government overturned over 3 000 regional regulations that were inconsistent with the law and national priorities. As recommended earlier, the longer-term solution is to give sub-national governments access to a broad-based growth tax, such income taxes, and thereby reduce their dependence on nuisance transaction taxes.

Recommendations to refine decentralisation and boost regional development

Sharpen incentives for regional business development

- Work with the sub-national governments to move the regulation of business to best practice. Review existing tax and other fiscal incentives to business investment in the regions. Consider a broader set of instruments for attracting businesses to the regions, including more flexible labour market policies.
- Experiment with different incentives in special economic zones, including more flexible labour regulation, with a view to extending proven good practices to the whole economy. Put in place the required infrastructure.

Better targeting fiscal transfers and raising more regional revenue

- Expand assistance to help regions to improve budget planning and implementation capacity. In the interim, make greater use of special allocation funds to prioritise sub-national spending.
- Change the mix of central government grants to all sub-national governments so that more is tied to specific programmes. This implies making greater use of the Special Allocation Fund (DAK).
- Do more to encourage sub-national governments to develop their own sources of revenue, such as by offering matching grants. Modify the transfer formula so that it does not penalise jurisdictions that exploit more fully their own fiscal capacity.
- Reform General Allocation Fund (DAU) transfers so they do not cover the full marginal cost of regional civil servants' pay.

Village transfers and governance

- Reform the system of village transfers to account for population size and poverty prevalence for the basic allocation. Make greater use of earmarked grants for village capital needs.
- Make explicit villages' service delivery responsibilities, and develop audit mechanisms that oversee their budgets.

Addressing regional fragmentation

- Freeze the formation of new sub-national jurisdictions (above the village level) until a comprehensive set of guidelines is in place to assess each application. Audit all existing villages to assess their economic viability, and encourage mergers where they are deemed unsustainable.
- Prioritise the task of mapping administrative sub-national jurisdictional boundaries.

Improving regional government service delivery performance

- Develop a comprehensive set of performance indicators that can be used to compare and assess outcomes at all sub-national levels of government and to provide them with more technical assistance.
- Encourage sub-national governments to emulate the best performing jurisdictions in terms of business registration and regulation.

Enhancing education outcomes across all regions

- Assist sub-national governments in meeting education quality targets.
- Reward teachers for performance and not just academic qualifications and seniority.

Sharpening incentives for regional infrastructure investment

- Make greater efforts to align sub-national projects with national strategies (such as MP3EI).
- Improve the central/sub-national budget process to reduce uncertainties and interruptions that are inhibiting complex multi-year infrastructure projects.
- Provide fiscal incentives to sub-national governments to ensure adequate road maintenance. For example, national co-financing of sub-national road investment could be made conditional on such maintenance.

- Make land acquisition laws more flexible so as to encompass regional cultural diversity.

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